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How Much SMidCap Exposure?

Small- to mid-cap stocks (smidcaps) have had an extended period of out-performance since 1999. The outsized returns delivered by this market cap segment have attracted considerable attention, and investors may wonder if it's too late to add exposure to smaller stocks. Below, we offer a few items for your consideration in determining how much exposure to smid-cap stocks one should maintain.

Asset Allocation

Historically, smaller stocks have higher expected return and higher risk than their large-cap counterparts. Because historically they do not carry a perfect correlation with large stocks, adding small caps to your portfolio may enhance return and reduce overall risk. Modern Portfolio Theory tells us an optimal portfolio is one which offers

the best risk/return profile. Using that notion, an optimal mix may be 75% large-cap and 25% smid-cap stocks.

- Over the past 28 years, the small/ midcap (SMidCap) Russell 2500 Index has posted an annualized return of 14.74%, versus the S&P 500's annualized return of 13.44%. (For reference, the Russell 2000 Index has returned 13.38% per annum.)
- The annual standard deviation of the Russell 2500 Index return over the same period is 17.77%, versus 14.87% for the S&P 500. (For reference, the annualized standard deviation of the Russell 2000 is 19.30%. See Table 1.)
- The Russell 2500 Index has a correlation with the S&P 500 of 0.86, and a near-perfect correlation of 0.99 with the Russell 2000 (see Table 2).

Firm Overview

- A pioneer in advanced quantitative investment strategies
- Founded in 1996
- Based in Safety Harbor, FL
- Majority-owned affiliate of State Street Global Alliance, LLC
- Principals own meaningful equity stake
- Manages approximately \$2.0 billion for clients in the U.S. and Europe
 - MaxCap
 - MaxCap Value
 - LargeCap
 - LargeCap Socially Responsible
 - Enhanced S&P 500
 - AllCap
 - TaxManaged AllCap
 - TaxManaged LargeCap
 - SMidCap

Table 1

	Ann. Ret.	Ann. Risk
S&P 500	13.44%	14.87%
Russell 2500	14.74%	17.77%
Russell 2000	13.38%	19.30%

*Data Source: Standard & Poor's, Russell Mellon

Table 2

	S&P 500	FR2000	FR2500
S&P 500	1.00		
Russell 2500	0.86	1.00	
Russell 2000	0.80	0.99	1.00

*Data Source: Standard & Poor's, Russell Mellon

- Because of the Russell 2500 Index returns and the benchmark's less-than-perfect correlation with the large-cap S&P 500 Index, a blended portfolio of large- and smid-cap stocks dominates both a pure large-cap portfolio and a blended portfolio of large-cap and small-cap stocks (see Chart 1).
- Finally, given the above, we search for the optimal blend of large-cap and smid-cap stocks. The scattergram in Chart 2 identifies the risk and return profiles of large-cap and smid-cap blends, with the smid-cap exposure increasing from 0% to 100% in increments of 5%.

The Efficient Market Hypothesis, meanwhile, tells us that we should use market exposure as our guideline in determining proper exposure to an asset class. We measured the total market capitalization of the Russell 3000 Index and the Russell 2500 Index over the past 112 quarters. By dividing the latter into the former, we can determine what percentage of the Russell 3000 consists of smid-cap stocks. Employing this approach, we arrive at a similar conclusion of the optimal smid-cap allocation (see Chart 3).

Increasing Benefits of Diversification

As globalization increases, performance of larger stocks and smaller stocks may diverge, as large companies derive significant revenue from overseas, small stocks significantly less. Above, we referenced the fact that over the past 28 years, the correlation between the S&P 500 and the Russell 2500 Index is 0.86. However, as the global economy becomes increasingly integrated, this correlation is generally decreasing. As such, the benefits of diversifying among large- and smid-cap stocks may be increasing (see Chart 3).

Chart 1

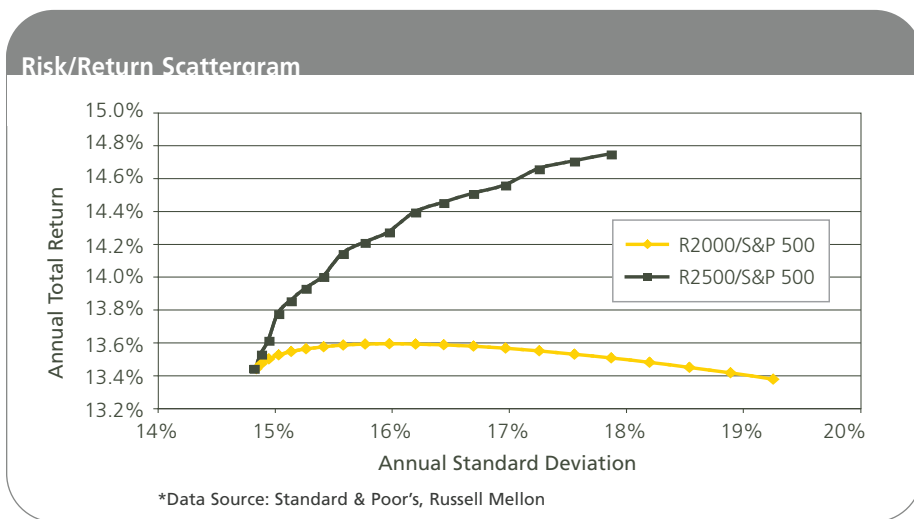


Chart 2

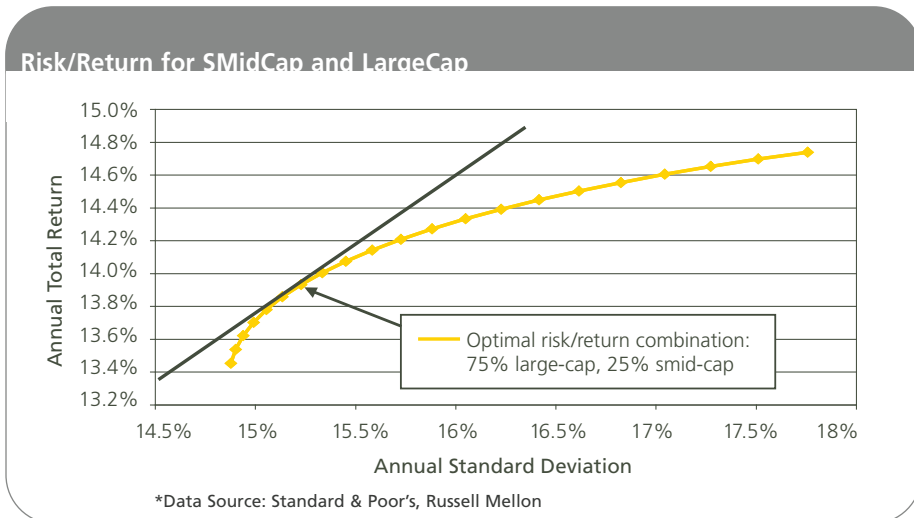
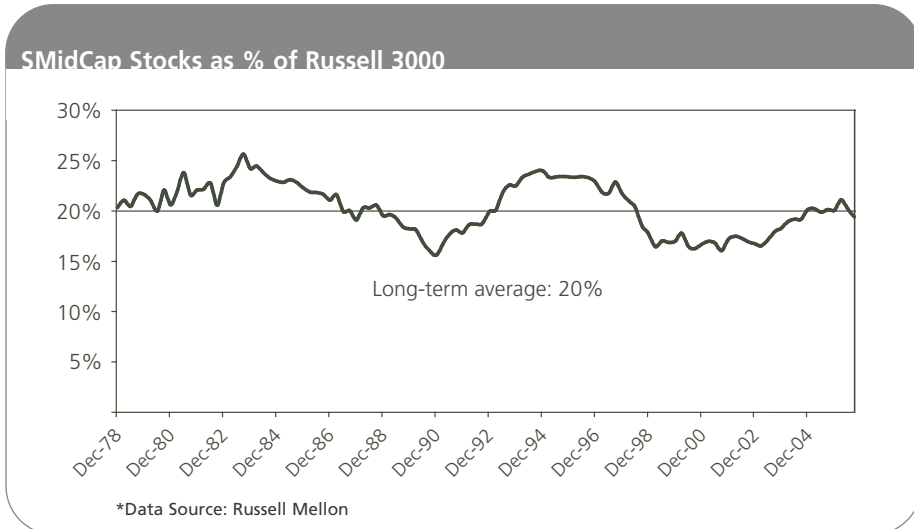


Chart 3



Benefits of Neglect

There has been considerable research regarding the performance of “neglected,” or under-followed, firms. Lower levels of analyst coverage are associated with higher returns, regardless of firm size. Several theories have been put forth to explain this effect. Investors may be willing to pay a higher price for stocks that recognized “brand,” despite the fact that future returns may be lower. Another theory is that news may be incorporated less slowly for under-followed stocks, and thus they are more prone to the impact of long-term price momentum. A third theory posits that less-followed firms are simply less efficiently priced (and more volatile), and therefore may offer higher returns. Under each of these theories, neglected stocks outperform stocks with greater analyst coverage (see Table 3).

Reports also indicate that on average, while only 32.6% of all large-cap managers have trumped the S&P 500, 40.8% of all mid-cap managers topped the S&P 400, and 49.5% of all small-cap managers beat the S&P 600. This confirms the notion that small- and mid-cap stocks are less efficiently priced than their large-cap counterparts.

Size Rotation

As presented below, the performance swings between large-cap outperformance and small-cap outperformance can be significant in magnitude. While smid-caps have outperformed significantly over the past six to seven years, the magnitude of their outperformance is not nearly equal to the magnitude and duration of outperformance recorded by large-caps during the 1990's (see Chart 5).

Chart 4

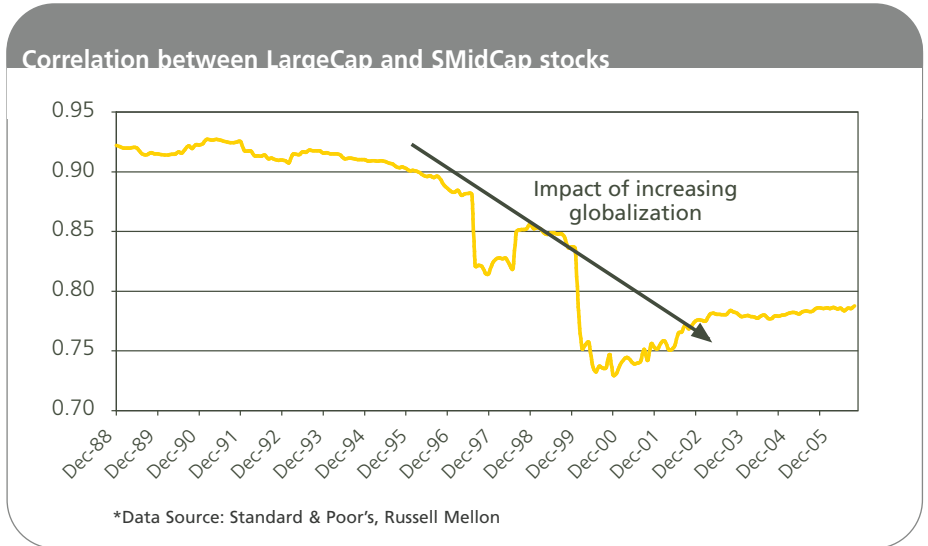


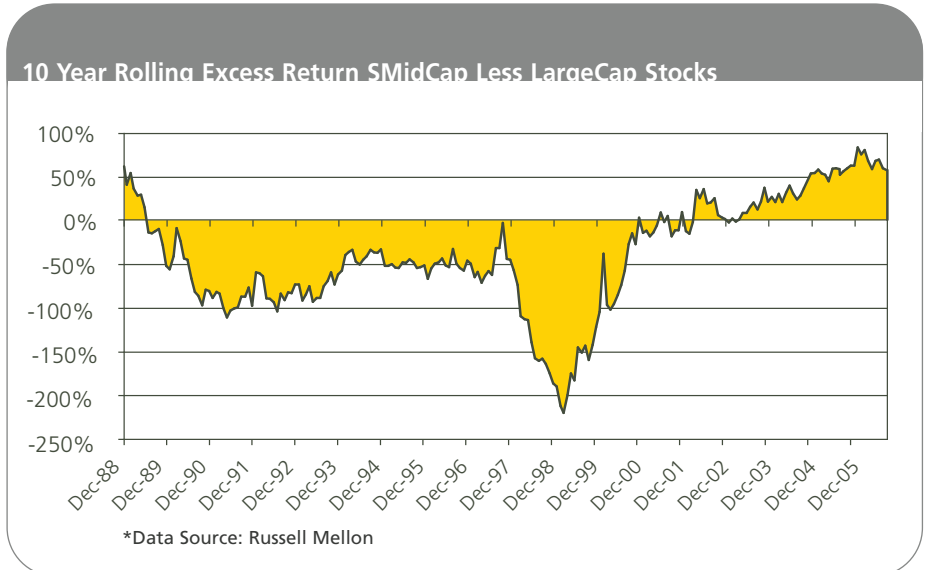
Table 3

Average Analysts' Coverage

S&P 500	15.4
Russell 2500	6.4

*Data Source: Standard & Poor's, Russell Mellon, IBES

Chart 5



Contact

Please address your inquiries
or provide feedback to:

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Loss Likelihood and Time Decay

We've already shown that when viewed separately, smid-cap stocks are slightly more risky than large-cap stocks. We've also shown that combining smid-caps with large-caps may lead to a better risk/return profile for investors.

Another way of potentially decreasing the risk of smid-cap stocks is through increasing the holding period. While smid-caps have greater risk, they may also have greater return potential. Thus, by increasing the duration of the holding period, the greater return potential slowly overwhelms the impact of higher volatility/greater risk.

Conclusion

We've presented a case as to why your smid-cap exposure may be better

than small-cap exposure, and why smid-cap exposure of 20-25% may be appropriate for suitable investors. We framed our reasoning in a risk/return discussion. While some may believe it's too late to gain exposure to this segment of the US equity market, many investors generally do not carry 20-25% of their domestic stock allocation in small- and mid-cap stocks. We believe that the diversification benefits of smid-cap exposure increase with time, and that the current length and magnitude of smid-cap outperformance falls well within observed norms. We also believe that while some believe stand-alone exposure to smid-cap stocks is too risky, even that risk may be mitigated with a sufficiently long holding period.

Table 4

Loss Probability	S&P 500	FR2500
1 Year	10.9%	11.2%
3 Year	10.4%	3.7%
5 Year	12.0%	0.7%
10 Year	0%	0%

January 1978 – November 2006; past results do not ensure future results.

¹ Pradhuman, Satya D., Merrill Lynch, Asset Allocation – Update on Framing the Size Dilemma, January 17, 2006.

MaxCap

Contact firm for information on MaxCap Value.

Benchmark

S&P 100

Quarterly Performance Attribution

Best Active Performance Policies:

- Style – Overweight Momentum, Underweight Yield
- Sector – Underweight Consumer Cyclical; underweight Basic Materials
- Industry – Underweight Department Stores; overweight Internet
- Stocks – Overweight Chevron, IBM, Hewlett Packard, and Goldman Sachs; underweight AT&T

Worst Active Performance Policies:

- Style – Overweight Earnings Yield, Trading Activity, and Earnings Variation
- Sector – Overweight Financials
- Industry – Overweight Securities & Asset Management, Information Services, and Oil Refining
- Stocks – Overweight Anheuser Busch, Xerox, Microsoft, Boeing, and Abbott Labs

Portfolio Content

Universe	S&P 100
Trailing 12-month Turnover	85%
Number of Holdings	35
Cash Level	2.8%

Top Ten Holdings

- | | |
|---|--|
| <ul style="list-style-type: none"> • ExxonMobil • General Electric • Chevron • IBM • Hewlett Packard | <ul style="list-style-type: none"> • Microsoft • Google • CVS Caremark • AT&T • Bank of America |
|---|--|

Portfolio Characteristics

Barra Risk Factors	MaxCap	S&P 100	Difference
Currency Sensitivity	0.01	0.00	0.01
Earnings Variation	-0.15	-0.20	0.05
Earnings Yield	0.24	0.18	0.06
Growth	0.02	-0.09	0.11
Leverage	-0.27	-0.26	-0.01
Momentum	0.07	-0.08	0.15
Size	0.95	0.98	-0.03
Trading Activity	-0.05	-0.16	0.11
Value	-0.09	-0.05	-0.04
Volatility	-0.25	-0.28	0.03
Yield	0.11	0.24	-0.13

Sector Weights

Sector Weights	MaxCap	S&P 100	Difference
Consumer Discretionary	7.7%	5.0%	2.7%
Consumer Staples	5.3	10.1	-4.8
Energy	17.2	12.7	4.5
Financials	24.4	22.5	1.9
Health Care	5.5	10.6	-5.1
Industrials	6.7	6.7	0.0
Materials	5.3	3.5	1.8
Retail	2.1	3.4	-1.3
Services	5.6	7.0	-1.4
Technology	20.2	16.9	3.3
Utilities	0.0	1.6	-1.6

Performance (as of 09.30.07)

Performance	MaxCap Pure Gross of Fees ²	MaxCap Net of Fees	S&P 100
Third Quarter 2007 ¹			
Year to Date 2007 ¹			
Annualized			
Total			
Return			
Inception Date – 7.1.98			

For performance data, contact Laurie Watson at (888) 248-8324

LargeCap

Enhanced S&P 500

S&P 500

S&P 500

Best Active Performance Policies:

- Style – Overweight Momentum
- Sector – Overweight Energy
- Industry – Overweight Oil Services; underweight Specialty Retail
- Stocks – Overweight Humana, Fluor, Freddie Mac, Goldman Sachs, and Valero Energy

Worst Active Performance Policies:

- Style – Overweight Leverage, Trading, Earnings Yield
- Sector – Underweight Technology; overweight Consumer Services
- Industry – Overweight Publishing; underweight Defense & Aerospace
- Stocks – Overweight Sears Holdings, Google, Mastercard, Lexmark, and DuPont

Best Active Performance Policies:

- Style – Overweight Momentum
- Sector – Underweight Consumer Cyclical; overweight Energy
- Industry – Underweight Department Stores; overweight Oil Services
- Stocks – Overweight Cummins, Humana, Biogen, Fluor, and Jones Apparel Group

Worst Active Performance Policies:

- Style – Overweight Leverage, Earnings Yield, and Trading Activity
- Sector – Underweight Technology; overweight Consumer Services
- Industry – Overweight Publishing; underweight Defense & Aerospace
- Stocks – Overweight Compuware, Wyeth, Moody's, Ambac Financial Group, and Sears Holdings

Universe S&P 500 + 400 largest in Russell 1000
 Trailing 12-month Turnover 110%
 Number of Holdings 63
 Cash Level 1.0%

Universe S&P 500
 Trailing 12-month Turnover 113%
 Number of Holdings 160
 Cash Level 0.8%

- ExxonMobil
- Chevron
- Google
- Bank of America
- Pepsico

- Humana
- Goldman Sachs Group
- Celgene
- Hewlett Packard
- Fannie Mae

- ExxonMobil
- General Electric
- AT&T
- Microsoft
- Bank of America

- IBM
- Procter & Gamble
- Google
- Wells Fargo
- Schlumberger Ltd.

Barra Risk Factors	LargeCap	S&P 500	Difference
Currency Sensitivity	0.00	-0.01	0.01
Earnings Variation	0.01	-0.08	0.09
Earnings Yield	0.16	0.10	0.06
Growth	0.09	-0.07	0.16
Leverage	0.02	-0.12	0.14
Momentum	0.09	-0.05	0.14
Size	0.36	0.40	-0.04
Trading Activity	0.15	0.01	0.14
Value	-0.01	-0.02	0.01
Volatility	-0.16	-0.13	-0.03
Yield	0.04	0.08	-0.04

Barra Risk Factors	Enhanced S&P 500	S&P 500	Difference
Currency Sensitivity	-0.04	-0.01	-0.03
Earnings Variation	-0.06	-0.08	0.02
Earnings Yield	0.07	0.10	-0.03
Growth	-0.02	-0.07	0.05
Leverage	-0.06	-0.12	0.06
Momentum	0.02	-0.06	0.08
Size	0.34	0.40	-0.06
Trading Activity	0.08	0.01	0.07
Value	-0.01	-0.02	0.01
Volatility	-0.12	-0.13	0.01
Yield	0.01	0.08	-0.07

Sector Weights	LargeCap	S&P 500	Difference
Consumer Discretionary	9.9%	6.2%	3.7%
Consumer Staples	6.3	8.3	-2.0
Energy	15.4	11.1	4.3
Financials	24.6	21.8	2.8
Health Care	13.3	11.7	1.6
Industrials	2.2	7.0	-4.8
Materials	4.8	4.4	0.4
Retail	3.2	4.6	-1.4
Services	5.4	6.1	-0.7
Technology	10.9	15.5	-4.6
Utilities	4.0	3.3	0.7

Sector Weights	Enhanced S&P 500	S&P 500	Difference
Consumer Discretionary	7.3%	6.2%	1.1%
Consumer Staples	6.9	8.3	-1.4
Energy	12.2	11.1	1.1
Financials	22.5	21.8	0.7
Health Care	12.7	11.6	1.1
Industrials	6.1	7.0	-0.9
Materials	4.2	4.4	-0.2
Retail	5.4	4.6	0.8
Services	5.9	6.1	-0.2
Technology	13.6	15.6	-2.0
Utilities	3.2	3.3	-0.1

Performance	LargeCap Pure Gross of Fees ²	LargeCap Net of Fees	S&P 500
Third Quarter 2007 ¹	<div style="border: 1px solid black; padding: 10px; text-align: center;"> For performance data, contact Laurie Watson at (888) 248-8324 </div>		
Year to Date 2007 ¹			
Annualized Total Return			
1 year			
3 years			
Since Inception ¹	Inception date – 5.1.99		

Performance	Enhanced S&P 500 Gross of Fees	Enhanced S&P 500 Net of Fees	S&P 500
Third Quarter 2007 ¹	<div style="border: 1px solid black; padding: 10px; text-align: center;"> For performance data, contact Laurie Watson at (888) 248-8324 </div>		
Year to Date 2007 ¹			
Annualized Total Return			
1 year			
2 years ¹			
Since Inception ¹	Inception Date – 11.01.02		

AllCap

Russell 3000

Best Active Performance Policies:

- Style – Overweight Momentum
- Sector – Overweight Basic Materials
- Industry – Overweight Oil Services; underweight Property/Casualty Insurance
- Stocks – Overweight Humana, Hewitt Associates, Goldman Sachs, Valero Energy, and Arrow Electronics

Worst Active Performance Policies:

- Style – Overweight Leverage, Trading Activity, and Value
- Sector – Overweight Commercial Services and Consumer Cyclical
- Industry – Underweight Energy Reserves; overweight Department Stores and Industrial Services
- Stocks – Overweight Nutri System, Sears Holdings, Microsoft, DuPont, and Hudson Highlands

Universe Russell 3000
Trailing 12-month Turnover 113%
Number of Holdings 63
Cash Level 0.7%

- JP Morgan Chase
- Pepsico
- Goldman Sachs Group
- Google
- Humana

- General Electric
- El du Pont de Nemours
- Chevron
- Diamond Offshore Drilling
- Microsoft

Barra Risk Factors	AllCap	Russell 3000	Difference
Currency Sensitivity	-0.03	0.00	-0.03
Earnings Variation	0.12	0.03	0.09
Earnings Yield	0.16	0.00	0.16
Growth	0.16	0.01	0.15
Leverage	0.20	0.01	0.19
Momentum	0.18	0.01	0.17
Size	-0.17	-0.06	-0.11
Trading Activity	0.15	0.03	0.12
Value	0.08	0.00	0.08
Volatility	0.06	0.04	0.02
Yield	-0.09	-0.01	-0.08

Sector Weights	AllCap	Russell 3000	Difference
Consumer Discretionary	9.4%	7.4%	2.0%
Consumer Staples	4.1	7.3	-3.2
Energy	10.6	10.4	0.2
Financials	22.5	21.1	1.4
Health Care	11.6	11.6	0.0
Industrials	2.2	7.3	-5.1
Materials	7.2	4.8	2.4
Retail	4.4	4.9	-0.5
Services	8.9	6.7	2.2
Technology	14.3	15.1	-0.8
Utilities	4.8	3.4	1.4

Performance
Third Quarter 2007¹
Year to Date 2007¹
Annualized
Total
Return
Since Inception¹

AllCap Pure Gross of Fees² AllCap Net of Fees Russell 3000

For performance data,
contact Laurie Watson at
(888) 248-8324

Inception Date – 1.1.97

SMidCap

Russell 2500

Best Active Performance Policies:

- Style – Overweight Momentum; underweight Yield
- Sector – Overweight Sports and Consumer Cyclical; underweight Financials
- Industry – Overweight Airlines, Equity REITs, and Oil Services
- Stocks – Overweight TBS International, UAL, Fresh Del Monte, Dreamworks Animation, and Discovery Holding Company

Worst Active Performance Policies:

- Style – Overweight Leverage, Value, and Trading Activity
- Sector – Underweight Industrials and Technology; overweight Consumer Services
- Industry – Underweight Energy Reserves and Biotech; overweight Consumer Durables
- Stocks – Overweight Nutri System, Energy Conversion Device, LaBranch & Company, TRW Automotive Holdings, and H&E Equipment Services

Universe Russell 2500
Trailing 12-month Turnover 105%
Number of Holdings 125
Cash Level 1.3%

- Discovery Holding Company
- Toro
- Dreamworks Animation
- Arrow Electronics
- UAL

- CF Industry Holdings
- Vail Resorts
- Janus Capital Group
- Alleghany Corp.
- Fairchild Semiconductor Intl.

Barra Risk Factors	SMidCap	Russell 2500	Difference
Currency Sensitivity	-0.08	0.04	-0.12
Earnings Variation	0.54	0.39	0.15
Earnings Yield	-0.25	-0.35	0.10
Growth	0.19	0.20	-0.01
Leverage	0.65	0.54	0.11
Momentum	0.27	0.11	0.16
Size	-2.16	-2.09	-0.07
Trading Activity	0.29	0.14	0.15
Value	0.24	0.15	0.09
Volatility	0.85	0.77	0.08
Yield	-0.42	-0.29	-0.13

Sector Weights	SMidCap	Russell 2500	Difference
Consumer Discretionary	15.4%	10.7%	4.7%
Consumer Staples	5.0	2.9	2.1
Energy	6.3	5.5	0.8
Financials	19.3	19.5	-0.2
Health Care	10.0	11.6	-1.6
Industrials	10.8	9.3	1.5
Materials	8.3	7.4	0.9
Retail	2.7	6.3	-3.6
Services	7.1	8.6	-1.5
Technology	12.5	13.9	-1.4
Utilities	2.6	4.3	-1.7

Performance
Third Quarter 2007¹
Year to Date 2007¹
Annualized
Total
Return
Since Inception¹

SMidCap Gross of Fees SMidCap Net of Fees Russell 2500

For performance data,
contact Laurie Watson at
(888) 248-8324

Inception Date – 11.01.02

Notes to Composite Performance Presentations

Advanced Investment Partners is a registered investment advisor specializing in the professional management of investment portfolios utilizing advanced quantitative techniques. The firm claims compliance with the Global Investment Performance Standards (GIPS®).

Beginning January 1, 2000, Advanced Investment Partners has engaged independent accountants to verify the firm's compliance with GIPS and to perform individual performance composite exams for the firm. To receive a complete list and description of the firm's composites and/or a presentation that adheres to the GIPS Standards, contact Advanced Investment Partners at (727) 799-3671 or write Advanced Investment Partners, 100 Main Street, Suite 301, Safety Harbor, FL 34695.

In each of its investment strategies, the firm seeks to outperform the stated benchmark over time through superior stock selection combined with rigorous, precise portfolio risk management. Accounts under each Composite strategy will hold a diversified portfolio of common stocks that in aggregate exhibit investment characteristics and industry representations similar to those of the strategy's benchmark index. Performance results represent a market value-weighted composite of all discretionary accounts under the respective investment strategy, calculated on a time-weighted basis for cash flows on a monthly basis, including the reinvestment of dividends, interest and capital gains. Historical portfolio returns are calculated by linking individual monthly returns. Pure Gross of fee returns are presented as supplemental information and do not reflect the deduction of investment management fees or bundled fees for certain accounts where transaction costs cannot be identified separately from other service fees charged by the client's broker/dealer or outside custodian. Gross of fee returns deduct transaction fees but do not take into account investment management fees, brokerage fees or bundled fees paid for certain accounts where transaction costs cannot be identified separately from other service fees charged by the client's broker/dealer or custodian. Net of fee returns reflect the deduction of investment management fees, brokerage fees and bundled fees as applicable. Composite returns, both historic and future, will be impacted by the same material market and economic conditions that influence the benchmark index. All returns have been calculated in U.S. dollars. COMPOSITE RETURNS REPRESENT PAST PERFORMANCE AND ARE NOT PREDICTIVE OF FUTURE RESULTS.

Each strategy's performance composite and related benchmark index are defined as follows:

LargeCap-Institutional Composite

includes all discretionary accounts greater than \$3 million managed under the LargeCap strategy where the firm is authorized with best execution trading responsibility. The LargeCap institutional composite is benchmarked to the S&P 500 Index, a broad based market value weighted index of 500 stocks chosen by committee at Standard and Poor's Corp. for their size and industry characteristics.

Enhanced S&P 500 Composite includes all discretionary accounts managed under the Enhanced S&P 500 strategy. The Enhanced S&P 500 composite is benchmarked to the S&P 500 Index, a broad based market value weighted index of 500 stocks chosen by committee at Standard and Poor's Corp. for their size and industry characteristics.

AllCap Composite includes all non-wrap discretionary accounts managed under the AllCap strategy and is benchmarked to the Russell 3000 Index. The Russell 3000 Index is an Index of U.S. stocks that represents approximately 98% of the U.S. equity market's total capitalization.

MaxCap Composite includes all discretionary accounts managed under the MaxCap Strategy and is benchmarked to the S&P 100 Index. The S&P 100 Index is widely regarded as a standard for measuring the performance of 100 of the very largest capitalization U.S. stocks as chosen by committee at Standard and Poor's Corp. for their size and industry characteristics.

SMidCap Composite includes all discretionary accounts managed under the SMidCap strategy. The SMidCap composite is benchmarked to the Russell 2500 Index, which measures the performance of the 2,500 smallest companies in the Russell 3000 Index and represents approximately 17% of the total market capitalization of the Russell 3000 Index.

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